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Dismissal for Bad-Faith Filing under §1112(b)(1): Whose Burden Is It, Anyway?

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The Bankruptcy Abuse Prevention Act and Consumer Protection Act of 2005 (BAPCPA) substantially overhauled §1112 of the Bankruptcy Code, which governs the conversion or dismissal of a chapter 11 case. The amendments expanded the grounds for conversion or dismissal, made the relief mandatory in the absence of "extraordinary circumstances" and imposed hard deadlines on the court for hearing and ruling on the motion. One amendment that has not received much press is the change from permitting dismissal or conversion "*for* cause" in the former §1112(b), to permitting conversion or dismissal "*if the movant establishes* cause" in the new§1112(b)(1).

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At first blush, this amendment may appear immaterial. Is it not axiomatic that any party seeking relief from the court must establish its entitlement to the relief sought? In jurisdictions that recognize a "bad-faith filing" as a "cause" for dismissal under §1112, this is less than clear.

Some "bad-faith filing" courts—in particular, the Third Circuit—have held that, upon a motion to dismiss for a bad-faith filing, *the debtor* bears the burden of establishing its good faith.[1] Interpreted literally, this would mean that a movant could merely recite "§1112(b)" and "bad faith" in a motion to dismiss, and the debtor would be forced to respond at the peril of the ultimate sanction of dismissal of its chapter 11 case.

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What is the harm in requiring a debtor to establish its *bona fides* in connection with the filing unless the debtor has something to hide? The trouble is that the "good-faith" inquiry has little to do with *bona fides* as such. As noted by one court canvassing the universe of bad-faith filing decisions at the time, "[t]here is actually no good faith element to the doctrine," and its application "does not depend upon the presence of any particular circumstances the courts list as relevant."[2]

As noted by another court, the concept of good faith "covers too many different kinds of conduct, in too many different situations" and "functions at such a high level of abstraction that one can scarcely discern what might be underneath it."[3] Indeed, even the most recent formulation of the "good-faith" standard by the Third Circuit, which issued three opinions between 1999 and 2004,[4] falls well short of bridging the gap between theoretical abstraction and practical application, describing the good-faith inquiry as a "fact intensive" examination of the "totality of the circumstances" to determine "where a petition falls along the spectrum ranging from the clearly acceptable to the patently abusive."[5]

Unfortunately, what appears "clearly acceptable" to one court may appear "patently abusive" to another.[6] As a result, when faced with a motion to dismiss for "bad faith filing"—however meritless it may appear on its face—the debtor is immediately at risk and cannot afford a measured response. It must respond perforce with every weapon in its litigation arsenal. If the movant bears *no* initial burden of coming forward with a case of "bad faith," the result is moral hazard, as the cost to the movant of filing and minimally prosecuting the §1112(b) motion will, almost inevitably, be vastly outstripped by the cost to the debtor of defending it. Against this backdrop, allocation of the initial burden of proof is not merely an academic exercise—it has real consequences for the balance of power and settlement leverage between the parties.

We submit that, properly understood, the "bad-faith filing" doctrine has always required *at least* a threshold showing by the movant of some bad faith on the part of the debtor before the burden shifts to the debtor to prove its good faith.[7] At any rate, to the extent that there was any principled basis for disagreement on this point pre-BAPCPA, we believe that the amendment from dismissal "for cause" to dismissal "if the movant establishes cause" settles it once and for all. Both points are more clear when viewed in

1 *See, e.g., NMSBPCSLDHB LP v. Integrated Telecom Express Inc. (In re Integrated Telecom Express Inc.),* 384 F.3d 108, 118 (3d Cir. 2004).

2 *In re Victoria Ltd. P'ship,* 187 B.R. 54, 62 (Bankr. D. Mass. 1995).

3 *In re Victory Constr. Co.,* 42 B.R. 145, 149 (Bankr. C.D. Cal. 1984).

4 *Integrated Telecom,* 384 F.3d 108; *PPI Enters.,* 324 F.3d 197; *SGL Carbon,* 200 F.3d 154.

5 *Integrated Telecom,* 384 F.3d at 118 (internal quotations omitted).

6 *See Santa Fe Minerals Inc. v. BEPCO LP (In re 15375 Mem'l Corp.),* 382 B.R. 548 and 386 B.R. 548 (Bankr. D. Del. 2008) (finding petitions were filed in good faith), *rev'd,* 400 B.R. 420, 429 (D. Del. 2009) (reversing, finding petitions were "much closer to the 'patently abusive' than to 'clearly acceptable' on the good faith spectrum").

7 *Accord In re Mirant Corp.,* No. 03-46590, 2005 Bankr. LEXIS 1686, *27 n. 20 (Bankr. N.D. Tex. Jan. 26, 2005).

context with the origin and development of the "good-faith filing" requirement.

The Bankruptcy Act of 1898

The good-faith filing requirement dates back to the Bankruptcy Act of 1898. Under the Act, entry of an order for relief was not automatic upon the commencement of a voluntary bankruptcy case. Rather, the debtor had to seek approval of its petition from the court. Chapter X, which governed reorganizations of corporations with publicly-traded securities, directed the court to "enter an order approving the petition, if satisfied that it complies with the requirements of th[at] chapter and has been filed in good faith, or dismissing it if not so satisfied."[8] The statute went on to provide four circumstances in which a petition would be "deemed not to be filed in good faith," including that "it is unreasonable to expect that a plan of reorganization can be effected."[9]

Neither chapter XI (governing "arrangements") nor chapter XII (governing real estate arrangements by persons other than corporations) contained a provision conditioning the acceptance of a debtor's petition on the debtor's "good faith." Nevertheless, some courts "were not hesitant to use the concept of good faith as an implied requirement for filing and maintaining a case under these chapters in spite of an absence of a specific requirement to show good faith."[10] The essential justification for this approach was the court's inherent equitable authority to prevent an abuse of process, such as when a debtor invoked the provisions of the Act to accomplish an objective antithetical to its purposes.[11]

The concept of "good faith" under the Act had two distinct senses. First, the *presence* of good faith was viewed as a threshold eligibility requirement for obtaining relief under the Act, whether by statutory mandate as in chapter X, or by judicial gloss on the statute as in chapters XI and XII. Second, the *absence* of good faith (or perhaps more accurately, the *presence* of *bad faith*) was viewed as a threat to the court's jurisdictional integrity, which justified the court's use of its equitable powers to prevent an abuse of process.

Bankruptcy Reform Act of 1978 and Early Case Law

The Bankruptcy Reform Act of 1978 "fused the former Chapter X, XI, and XII into one single unitary relief chapter, Chapter 11."[12] In contrast to the Act's requirement of court approval of a petition, the Code made entry of an order for relief under any chapter automatic upon the filing of a petition by an entity that may be a "debtor" under that such chapter.[13] Section 109 of the Code, which governs who may be a debtor, provides limitations as to the types of entities that may qualify for chapter 11 relief, but does not otherwise contain any eligibility requirements such as a "good faith filing."[14] The minutes of the Commission on the Bankruptcy Law of the United States, the original draftsmen of the Bankruptcy Code, suggest that this omission was intentional.[15]

While some lower courts in the Third Circuit have interpreted SGL Carbon*'s "once at issue" language to mean the movant must make a threshold showing of bad faith before the burden shifts to the debtor to prove its good faith, the Third Circuit's more recent formulations of the burden seem to foreclose such an interpretation.*

The commission considered the "good faith" requirement to "encourage and require secured creditors unnecessarily to litigate the issue of good faith at an earlier stage in order to lift the stay against exercise of their repossession or foreclosure remedies," which was "usually premature, if based on lack of good faith in the sense that there was no possibility of a feasible plan."[16] While it was acknowledged that secured creditors should have an opportunity to challenge the stay (as distinct from the pendency of the case itself), "[i]t was generally agreed that the good-faith test should be replaced with specific grounds for dismissing or adjudicating a Chapter case, either on a creditor's application or on the court's own initiative."[17]

The commission's recommendations were ultimately reflected in the Code as enacted. The "good faith" requirement was not carried forward into §109, and the absence of a reasonable likelihood of an effective plan (one of the species of "bad faith" under the Act) was carried forward, with certain modifications, as among the nonexclusive examples of "cause" for dismissal in §1112(b).[18]

Notwithstanding Congress's apparently intentional restructuring of the "good faith" requirements in chapter 11, bankruptcy courts continued to look to pre-Code precedent for guidance. Some courts found that the concept of "cause" in §1112(b) was sufficiently flexible to encompass a debtor's bad-faith filing, which dovetailed with the pre-Code precedent that invoked the good-faith requirement as a check against an abuse of process.[19] Other courts imported the pre-Code "good faith" case law and analysis—*both* in its threshold-eligibility *and* jurisdictional-integrity sense—wholesale into the Code without any apparent statutory basis.[20] Over time, courts recognizing a "good faith" requirement under the Code formulated the doctrine "in such a way as to bar from chapter 11 debtors having the following characteristics: one asset, few employees, few unsecured creditors, difficulties with only one creditor, and the absence of an ongoing business."[21]

Toibb v. Radloff

In 1990, a circuit split developed as to whether a chapter 11 filing by an individual debtor who was not engaged in business could satisfy the "good-faith" requirement. The Eleventh Circuit had reversed a bankruptcy court's *sua sponte* dismissal of an individual chapter 11 debtor's case, finding that the debtor's lack of business operations, without more, was not indicative of bad faith on the debtor's part.[22] The Eighth Circuit had affirmed a bankruptcy court's *sua sponte* dismissal of an individual debtor's chapter 11 case, concluding that an ongoing business was a condition of eligibility for chapter 11 relief.[23] The

8 Bankruptcy Act of 1898, §141, 11 U.S.C. §541 (1976) (repealed 1978).
9 Act §146, 11 U.S.C. §546 (1976) (repealed 1978).
10 *In re Herndon Exec. Ctr. Inc.,* 36 B.R. 803, 805 (M.D. Fla. 1984) (citing cases).
11 *See id.*

12 *Id.*
13 11 U.S.C. §301.
14 *See* 11 U.S.C. §109(d).
15 *See* Frank R. Kennedy and Gerald K. Smith, "Postconfirmation Issues: The Effects of Confirmation and Postconfirmation Proceedings," 44 *S.C. L. Rev.* 621, 732-33 n. 409.
16 *See id.* (quoting Gerald K. Smith and Randolph J. Haines, "Chapter 11 Reorganization," 1988 *Ann. Surv. Bankr. L.* 495, 498-509 (1989)).
17 *Id.*

18 *See* 11 U.S.C. §1112(b)(1)-(3) (1978).
19 *See, e.g., In re Northwest Recreational Activities Inc.,* 4 B.R. 36, 39-40 (Bankr. N.D. Ga. 1980) (Norton, J.) (finding "dismissal for lack of 'good faith' as distinguished in the jurisdictional integrity sense...is not precluded by the new Code").
20 *See, e.g., In re Victory Constr. Co.,* 9 B.R. 549, 558 (Bankr. C.D. Cal. 1981) (finding good-faith filing requirement "had been established and accepted as part of bankruptcy philosophy (either by statute or decisional law) for almost a century" and "must therefore be viewed as an implicit prerequisite to the filing or continuation of a proceeding under Chapter 11 of the Code"), *vacated on other grounds,* 37 B.R. 222 (9th Cir. B.A.P. 1984).
21 *Victoria Ltd. P'ship,* 187 B.R. at 61.
22 *In re Moog,* 774 F.2d 1073 (11th Cir. 1985).
23 *In re Toibb,* 902 F.2d 14 (8th Cir. 1990), *rev'd sub nom. Toibb v. Radloff,* 501 U.S. 157 (1991).

Eighth Circuit based its ruling on prior precedent that had relied upon "bad faith filing" cases decided under §1112(b).[24]

The Supreme Court granted *certiorari* to resolve the circuit split, and ruled 8-1 that the plain language of §109 of the Code disposed of the question before it. The Court noted that Congress "knew how to restrict recourse to the avenues of bankruptcy relief" because it "took care in §109 to specify who qualifies—and who does not qualify—as a debtor under the various chapters of the Code."[25] Absent express guidance in the Code, the Court was "loath to infer the exclusion of certain classes of debtors from the protections of Chapter 11."[26]

Although *Toibb* did not discuss "good faith" as such, the decision very clearly stands for the proposition that courts are not at liberty to impose additional eligibility requirements for obtaining chapter 11 relief above and beyond the minimal requirements of §109(d). To the extent that the "good-faith filing" doctrine survived *Toibb* at all,[27] it could have survived only as a check against abuse of process, not as a measure of a debtor's threshold eligibility for chapter 11 relief.

Life after Toibb: *Third Circuit*

In *SGL Carbon Corp.,* decided almost eight years after *Toibb,* the Third Circuit ruled that "Chapter 11 bankruptcy petitions are subject to dismissal under 11 U.S.C. §1112(b) unless filed in good faith."[28] As support for this proposition, the Third Circuit quoted at length from the portions of *Victory Construction Co.* and *Little Creek Development,* articulating a jurisdictional-integrity basis for the rule, though the court ultimately went on to articulate what appeared to be eligibility requirements for chapter 11 relief.[29]

After determining that §1112(b) imposes a "good faith" requirement, the court allocated the burden of proof as follows: "Once at issue, the burden falls upon the bankruptcy petitioner to establish that the petition has been filed in good faith."[30] The authority cited for this proposition was a pre-*Toibb* case, *Stage I Land Co. v. United States,* 71 B.R. 225, 229 (D. Minn. 1986), which in turn cites *In re Setzer,* 47 B.R. 340, 345 (Bankr. E.D.N.Y. 1985).

Setzer was a rather unique case that considered the respective burdens of production and persuasion in the context of a "bad faith" dismissal motion where neither the movant nor the debtor had presented any evidence. The *Setzer* court noted that §362(g) of the Code specifically allocated the burden of proof between movant and debtor in stay-relief matters, but that the Code was (then) "silent with regard to the burden of proof in dismissal motions." Turning to the then-extant authority (most of which was either decided under, or relied upon cases decided under, the Act), the *Setzer* court concluded unequivocally that "the debtor bears the burden of proving that the filing was made in good faith."[31]

While some lower courts in the Third Circuit have interpreted *SGL Carbon's* "once at issue" language to mean the movant must make a threshold showing of bad faith before the burden shifts to the debtor to prove its good faith,[32] the Third Circuit's more recent formulations of the burden seem to foreclose such an interpretation. In particular, in *Integrated Telecom,* the Third Circuit found that the bankruptcy court's

> statements that "it does not establish bad faith for a debtor to," or "I conclude that as a matter of law, that is not a debilitating fact," *erroneously suggest that the question before the court was whether bad faith, rather than good faith, had been proven.*[33]

As of the time that BAPCPA was enacted, the law in the Third Circuit appeared to be that the mere filing of a motion to dismiss for "bad faith" put the onus on the debtor to prove its entitlement to chapter 11 relief. This was so notwithstanding *Toibb's* admonition against imposing eligibility requirements upon chapter 11 debtors other than those specified in §109(d). To the extent the Third Circuit got it wrong, only a Supreme Court opinion, an *en banc* reconsideration or an act of Congress could remedy the situation. Then along came BAPCPA.

BAPCPA

As previously noted, BAPCPA amended §1112(b)(1) of the Bankruptcy Code to expressly require *the movant* to *establish* cause for dismissal. Although the amendment appears innocuous in itself, when one traces the origin of the Third Circuit's position on the burden issue back to its origin in *Setzer,* the amendment's effect becomes apparent.

As noted above, the *Setzer* court began its burden analysis by looking for direction from the statute. Not finding any such direction, it looked to pre-Code case law. Were the same court to consider the issue anew, it would be hard-pressed to conclude that the statute is "silent" as to the parties' respective burdens. The statute now provides clearly that the movant must establish "cause," and if the "cause" at issue is the debtor's bad faith, then the movant must establish it, as a matter of plain statutory language.

Conclusion

We believe that the dismissal for bad faith has always required at least a threshold showing by the movant of some bad faith on the part of the debtor. To the extent that there was any basis for disagreement on this point in the case law pre-BAPCPA, we believe that the amendment from dismissal "for cause" to dismissal "if the movant establishes cause" settles the issue. ■

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24 *Wamsganz v. Boatmen's Bank of De Soto,* 804 F.2d 503, 504 (8th Cir. 1986) (citing *In re Little Creek Dev. Co.,* 779 F.2d 1068, 1073 (5th Cir. 1986); *In re Winshall Settlor's Trust,* 758 F.2d 1136, 1137 (6th Cir. 1985)).
25 *Toibb,* 501 U.S. at 160-61.
26 *Id.*
27 *See Victoria Ltd. P'ship,* 187 B.R. at 61 (finding good-faith filing doctrine is in reality an "eligibility rule" is inconsistent with *Toibb*).
28 200 F.3d at 160.
29 *Id.* at 161 and 163-65 (holding chapter 11 filing requires "valid reorganizational purpose" and is not available to "financially healthy" company).
30 *Id.* at 162, n. 10.
31 47 B.R. at 345.
32 *See, e.g., Walden Ridge Dev.,* 292 B.R. at 62.
33 *Integrated Telecom,* 384 F.3d at 128 (emphasis added).